

Should the European Tier Play a Role in Prudential Supervision of Banks?

Iain Begg and David Green, IBL, South Bank University, London

1 Introduction

Although the Treaty on European Union is, in many respects, an ambitious blueprint for European integration, it has little to say about a number of areas of public policy. In some of these areas, no clear guidance is given about whether responsibility for policy should remain with Member States or be re-assigned to the supranational tier. By contrast, the assignment of competences is entirely explicit in other fields. Thus, monetary union will see the transfer of responsibility for monetary policy from Member States to the European Central Bank (ECB), while fiscal policy will remain with Member States. The uncertainty surrounding the future assignment of policy is most pronounced in areas in which the EU tier has had little to offer in the past (for example, industrial policy) or in which integration is, itself, engendering new policy demands. In the latter category, cross-border regulation is an instance of an issue which arises because of the consequences of integration.

The ECB, acting together with national Central Banks in what will be known as the European System of Central Banks (ESCB), will also have related responsibilities for assuring the viability of the European financial system. Yet even here there is ambiguity about where responsibilities will lie for different functions. Prudential supervision of banks - controls designed to assure the capital adequacy and liquidity of banks - is a good illustration of this. Thus, article 105 (5) of the Treaty states that the ESCB 'shall contribute to ... prudential supervision of credit institutions and the stability of the financial system' and in 105 (6) there is reference to the possibility that the ECB may be asked to undertake specific tasks in relation to 'prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings'. In the transition to EMU, the European Monetary Institute (EMI), which is the precursor to the ECB, is given the right to hold consultations on 'issues falling within the competence of the national central banks and affecting the stability of financial institutions and markets' (article 109f).

1.1 Why the issue matters

The banking system plays a central role in the operation of a modern economy both by providing the basis for payments and by acting as the principal intermediary between lenders and borrowers. As such it occupies a position similar to the electricity supply or telecommunications networks as a vital part of the economic infrastructure. If the stability of the system is undermined, considerable disruption can result, and, as recent experience in Scandinavia and the US (the savings and loans crisis) shows, a breakdown in the banking system can have substantial effects on the real economy.

For these reasons, banking is generally regarded as an industry that needs to be regulated with sensitivity. Bank regulators need to tread a careful path between controls which assure the stability of the financial system and over-bearing regulation which stultifies competition and efficiency. Regulation is further complicated by the parallel controls on banks that stem from the operation of monetary policy. Hitherto in the EU, both bank regulation and monetary policy have been competences of Member States. However, with responsibility from monetary policy being re-assigned to the supranational tier, it is reasonable to ask whether it would be rational also to re-assign responsibility for bank regulation, and particularly prudential supervision.

1.2 The current position

The motivations for prudential controls differ from country to country, reflecting both the historical development of regulatory practice and the character of their financial systems. In some countries, public ownership of major financial institutions predominates. Some countries have centralised financial systems in which major financial groups play a leading role, while in others, the system is fragmented either regionally or by type of service. Differences between countries in legal, political and institutional arrangements are compounded by contrasting market structures in financial services.

The manner in which the financial system has developed in any country is, inevitably, linked to its history, culture and pattern of development. As Khoury (1990) points out of the US system of regulation: it 'is based on an archaic collection of laws and regulations formulated in reaction to financial, economic and political crises.' The existing framework for prudential supervision, in short, is as much the result of historical accident as of the application of economic principles.

Within the EC, there are differences between Member States in both the institutional structures for, and the aims of, prudential supervision. As the table shows, the Central Bank takes the lead in roughly half the Member States, while a separate authority undertakes the main supervisory duties in the others. Even for the latter group, however, the Central Bank, as in France, has a substantial role in supervision. In Denmark, supervision of banks is carried out by an agency responsible for all financial services under the Ministry of Industry, while in Luxembourg, the Institut Monétaire Luxembourgeois has been neither a fully fledged Central Bank, nor a specialist banking commission (although the IML is changing because of EMU).

These supervisory structures have evolved considerably in the last decade (OECD, 1992), with a general tightening of prudential controls. There is evidence of a convergence in approaches (Gardener and Molyneux, 1990), helped by the agreement and adoption of international standards, such as the Cooke rules for capital adequacy, although major differences in supervisory methods remain. These concern such matters as the extent to which on-site inspections rather than examination of statistical returns is used, the role of external auditors, bank authorisation (that is, market entry) and recourse to closure. There are also substantial variations in deposit insurance schemes or in the legal liability of the regulators. Nevertheless, the trend is towards a de facto harmonisation.

1.3 Options for a European approach

Various reasons can be put forward for advocating an increased role for the European tier in any policy area, including those affecting the European financial system. Equally, there are pragmatic arguments against such a transfer of powers. To the extent that the Member States recognise some common ground, three broad approaches might be envisaged:

- No change in the current assignment of responsibilities between tiers of government, but establishment of procedures for co-operation between Member States. In essence, this is the case for fiscal policy and the régime of direct taxation to which financial intermediaries are subject.
- Setting-up of formal co-ordination mechanisms so that national administrations are tied in by rules. These can be reinforced by new institutions, a possible example being the European Monetary Institute, albeit for a transitional period.
- Assignment of new competences to the EU tier, possibly to complement the activities of parallel policy agencies in Member States, but typically requiring the creation of new institutions. For monetary policy, this, broadly is what will happen with the establishment of the ECB and the ESCB.

In practice, 'policy' comprises a variety of functions and activities by public agencies, so that a rigid demarcation of this sort is unlikely. A disjunction may, for example, be envisaged between the strategic choices and rule-setting for policy, and its implementation. For prudential supervision, this is likely to be of particular relevance in view of the need for supervisors to establish close and productive links with the intermediaries under their jurisdiction.

1.4 Broad trends in European banking

As the opening sentence of a recent OECD (1992) report on the banking sector notes, 'recent developments in the banking world have been turbulent.' Perhaps the most pervasive trend has been the progressive internationalisation of financial markets, a trend which has transformed the previously cosy relationships between leading banks and their respective national authorities. The advent of the single market and the enactment of the Second Banking Directive reinforced this trend in two ways. First, it made it easier for banks from one Member State to set up branches or subsidiaries in others.

Second, it prompted a wave of takeovers and alliances, as a result of which a few large banking groups are gradually becoming multi-national entities.

Other trends which radically alter the nature of the banking and finance industries also set new challenges for prudential control. These include: the integration of traditional banking activity and other market areas such as securities business or insurance, resulting in so-called universal banks; changes in the nature of the risks facing financial intermediaries; and the process of 'disintermediation' - lenders and borrowers coming together without making use of a financial intermediary. The internal organisation and procedures of financial entities have also evolved rapidly with ever-greater use of information technology. One outcome has been a proliferation in 'products' specifically designed for particular market segments.

1.5 Structure of the paper

The next section of this paper reviews the case for supervision of banks and other credit institutions. The following section outlines a series of new problems for prudential supervisors and reviews recent relevant experience in the United States and elsewhere. The discussion then turns to an assessment of the arguments surrounding the extent of the involvement that an EU tier of government should have in this arena. Finally, a number of conclusions and proposals are presented.

2 Why supervise: the nature of risks etc

Any form of regulation has to strike a balance between competing objectives, and prudential supervision is no exception. It is argued that controls are needed to deal with market failures arising from asymmetries in information and risks emanating from moral hazard, and the wider macroeconomic implications of bank failure, notably systemic risk (for a succinct exposition, see Tirole, 1994). At the same time, prudential controls need to be light enough to ensure that the financial system fulfils its function in the resource allocation process. Although regulation of banks tends to be seen as a duty the public sector needs to take on because of the scope for such market failures, some commentators argue that many of the aims of regulation could be achieved by affording greater play to market mechanisms (Benston, 1991), or that efforts to improve information flows could substantially reduce the scope for market failures (Dermine, 1994). The fact remains that banks have long been subject to extensive regulation, even though this regulation is not always rooted in sound conceptual analysis of relevant risks and costs (Tirole, 1994).

Two broad approaches to prudential supervision are adopted in the EU, exemplified by Belgium and the UK. For the former, the primary justification of prudential supervision is to guard against systemic risk, whereas in the UK the legal texts emphasise protection of depositors. From a practical perspective, however, the distinction between the two may not always be great because the instruments used to achieve the two classes of objective tend to be very similar and it is evident that bank supervisors do have to be alert to both aims in exercising their controls.

An extreme view is to regard regulation as an unnecessary market distortion and that competition should always be foremost. Benston (1991), for example, in a critical review of the record of bank regulation in the US, argues that systemic risk can, in practice, be avoided by a combination of monetary policy and the use of lender-of-last-resort intervention, rendering regulation unnecessary. He concludes that 'regulation has overwhelmingly tended to make the banking system and individual banks less stable.' However, many of the points he raises can be attributed more to the type of regulation practised in the US, than to weaknesses of regulation per se.

2.1 Systemic risk

Systemic risk is the textbook reason for prudential controls designed to assure bank solvency. It can be defined as the danger that an initial bank failure will spread to other banks in the system. This can happen if the failing bank has liabilities held as assets by other banks, with the result that they, in turn,

face a deterioration in the quality of their assets which could precipitate a domino effect (Paroush, 1988) of a run of withdrawals. Failure by one bank may, moreover, engender a lack of confidence that affects other financial intermediaries, even if they are not directly implicated. A related, though distinct risk is that of contagion within a financial conglomerate which results from one component of the conglomerate suffering losses which undermine the viability of the group (Dale, 1992). This can occur despite the core banking activity is perfectly sound, the demise of Barings being a prime example.

As the European financial system becomes more integrated, the ramifications of a bank failure will inevitably be greater, the more so as leading banks extend their operations across borders and into other segments of financial services. This means that the 'external costs' associated with a bank run would fall not only on the Member State in which the bank was subject to supervision, but also in partner countries. In so far as it is appropriate that supervision be carried out by the tier of government able to internalise the costs of systemic failure, this would argue for conferring responsibility on the supranational tier.

2.2 Protection of depositors

The justification for prudential controls aimed at protecting depositors is, essentially, that depositors lack the means to obtain information that would enable them to assess the solvency and viability of a bank. The high costs of monitoring stem from the asymmetry of information between depositors and bank managers because the large number of small depositors in a bank cannot easily combine to obtain such information (Dewatripont and Tirole, 1992).

In a more integrated financial system, an increase in cross-border selling of financial products must be expected - indeed, it is part of the rationale for the single market. This could aggravate the asymmetry of information between depositors and financial intermediaries and would imply a need for more robust supervision. Although the principle of home country control introduces a level playing-field from a competition perspective, it leaves a question mark over the motivations of bank supervisors when they are not directly accountable to depositors resident in another Member State. Competition imperatives and the corresponding national interest might also encourage laxity in supervision in order to secure activity in the financial sector. Even if primary responsibility for supervision remains with Member State supervisors, this points to a need not only for common rules on supervision and, possibly, supranational oversight of Member State supervisors (who supervises the supervisors?), but also for cross-border provision for indemnifying depositors.

2.3 Market conduct

A third consideration in regulation of the banking system is assuring the efficient functioning of the financial system. Efficiency requires the design of a set of optimal regulatory rules that ensure the cost of regulation is minimized yet its objectives are achieved. One function of regulation in this regard is to counter the adverse consequences of 'market failures' such as excessive concentration of market power (especially monopolies or cartels), or a lack of incentive to innovate in the interests of customers. The single market measures aimed at deregulating the banking and financial services industries plainly have this aim, and there is a clear role for the EU tier in policing competition.

The smooth operation of the payments systems failure is a further important element of the efficient functioning of a financial system Dewatripont and Tirole (1992). This is an area in which progress at the European level has been patchy and one of the priorities for the coming years will be to advance this process. It does, however, raise questions about where responsibility within the ESCB should lie for overseeing the system. In principle, this can be left to Member State central banks, but there will manifestly be a need for an inter-Member State clearing mechanism.

3 The underlying changes and why they change the position

Major structural changes in the financial services industry worldwide have re-shaped the challenge facing bank regulators. After a pause in the early 1990s, the banking and financial services industries

are continuing to undergo rapid, wide-ranging internationalization (BIS 1994: 95-9; IMF 1994: 72-5). The competitive pressures set free by liberalization are increasing banking efficiency but generating greater systemic and institutional risks (IMF 1993: 3-44). Amongst the most significant developments with which the banking industry and prudential supervisors must cope are:

- The progressive disappearance of restrictions concerned with quantitative, interest rate and terms of credit. Demand for credit is increasingly met through the operation of financial markets rather than by political or institutional mechanisms. This has given rise to the possibility of credit bubbles and crunches.
- The development of a much broader spectrum of financial instruments. Many of these are traded on markets rather than managed through institutions. This has given rise to the possibility of significant disintermediation. It has also made risk management more complex and important - particularly as some of the derivative financial instruments now available provide the opportunity for significant leverage. Banks have pushed and been pulled into new areas of business activity.
- The growth in the institutionalisation of savings. Personal sector savings increasingly take the form of investments by pension funds, insurance companies and collective investment institutions. This trend has led to banks having to pay more for the deposits they take whilst simultaneously creating powerful new potential competitors.
- The broadening of the scope of financial businesses. There is a pervasive trend to de-specialization of existing financial institutions. In addition there is a significant trend for non-financial institutions to enter into the provision of significant financial services. This has led to increased competition for existing banks and has also meant that many banks have felt compelled to enter new markets and learn new lines of business, sometimes with notably unsuccessful results.

In these circumstances the distribution and co-ordination of supervisory responsibilities has acquired substantial significance. The speed of internationalization, the rate of innovation and the rapidly changing scope of financial firms provide a background in which it is only prudent to expect financial turmoil to occur. The new European regulatory and supervisory system must prevent such turmoil when possible and tackle it promptly if and when it appears. This is no easy task as, by its very nature, financial turmoil is unexpected.

3.1 Supervisory challenges facing the European financial area

The upsurge in multinational banking is an irreversible trend that, itself, poses new challenges to regulators (Dale, 1981). Establishment of a single banking market in Europe takes this a stage further, and there are several reasons for expecting problems to occur as the European financial area comes into being.

First, the area brings together quite disparate financial markets. The financial services industry has been highly segmented along national lines and also, in some countries, along product lines. In some European Union economies, the financial environment has been highly protected (Greece); in others stability has been the norm (Germany); and some have suffered from considerable financial turmoil in recent years (Finland, Sweden). Elsewhere, the state plays a significant role at institutional level (France), others have been at the cutting edge of financial innovation and internationalization (United Kingdom). This very disparity is one of the underlying features likely to cause problems. It also provides a key argument behind the existing policy of home country control, namely that national supervisors have an unrivalled, intimate knowledge of their own national situation. The corollary of this is that it is national regulators which should be left to get on with the supervisory job. However, as the integrative and competitive processes initiated by the Europeanization of financial markets get underway this disparity is likely to prove an increasing source of potential problems as financial structures in some states undergo rapid structural change. As Loehnis (1993: 10) has observed an 'area where risk of failure is particularly salient concerns the friction of transition to new financial structures' (his emphasis).

A second reason for expecting trouble is that the 4,000 plus commercial and savings banks in the European Union are simply too numerous to survive in their present form (EC 1993). The processes of consolidation and 'downsizing' are most unlikely to be trouble free, as experience in the United States has indicated (BIS 1993: 168-81; White 1992). Furthermore, the banking industry in the European Union as a whole is substantially less concentrated than that of the United States whilst the five firm concentration ratios in each individual EU country are significantly higher (Baltensperger and Dermine 1993: 20-1). The Cecchini report (1988) projected that one third of the benefits arising from the creation of the single European market would be gained from efficiencies in financial services. The creation of a single European financial area is intended to bring about much greater competition. A significant increase in concentration at European Union level is also likely as some major banks bid to become genuinely pan-European institutions. One certain result is that there will be winners and losers from the more open competitive process. As the liquidation of banks may have much broader financial and economic consequences it is particularly important that arrangements for the orderly exit of unsuccessful firms are thought through in advance.

A third reason to anticipate problems is that there are major structural differences amongst the existing national markets. Even such basics as the scale of deposit insurance vary substantially. For example, the voluntary Italian scheme covers losses approximately 30 times greater than the £15,000 maximum covered by the UK system (Baltensperger and Dermine 1993: 29; Henderson 1993: 146). In addition there are basic differences in the principles of organization adopted by different financial systems which make harmonisation difficult. As Borio and Filosa (1994: 33) have recently observed 'The problem is that devising standards that are appropriate for institutions performing different ranges of activities has proved to be a very difficult task: the approaches historically adopted by the relevant authorities have been profoundly different'. One outcome of these differences is that a situation has been created in which it is easier to operate deliberately opaque corporate structures in order to take advantage of information and regulatory gaps between authorities. Such gaps were effectively exploited by the Bank for Credit and Commerce International (IMF 1992: 15-6).

A fourth cause for concern is that the new European structure with its emphasis on home country regulation may provide incentives for national regulators to transfer problems elsewhere. Vives (1993) observes that if the home country is responsible for solvency and the host country for deposit insurance then home country regulators have an incentive to be lax as calls on the deposit insurance system will be paid by foreign taxpayers. This problem has been mitigated but not eliminated by the adoption of minimum European Union standards of deposit insurance (IMF 1993: 40). In addition, it is highly likely that different national regulators will have substantially different political priorities concerning, for example, job protection and the creation of financial service 'national champions'.

3.2 Recent supervisory experience: lessons for the EU

Some insights into the potential pitfalls for the EU can be gleaned from the recent difficulties experienced in supervising banks in the United States.

3.2.1 US

After four decades of remarkable stability the latter part of the 1980s witnessed a dramatic upsurge in commercial bank failures in the United States (see table 2). Amongst the first problems with which US banking supervisors were presented as the era of stability ended was the effective failure in 1984 of Continental Illinois. At the time, Continental Illinois was one of the ten US money centre banks. Its losses and projected bankruptcy caused the Federal Reserve to organize a rescue operation which involved acting as a lender of last resort (Davis: 251). As table 2 illustrates commercial bank failures became common thereafter. Amongst the major reasons accounting for this dismal trend were increased economic instability generally (Minsky 1986) and specific regional recessions as exemplified by the dramatic downturn in Texas (Hooks, 1994: 2-3). De-regulation cut intermediation margins as banks were obliged to pay more competitive rates to depositors, whilst opening their previously protected markets to greatly increased competition from

both other banks and other financial and non-financial institutions. This quickly exposed the mistakes of poor quality managements (Smith 1993). Underlying structural changes such as increased competition for savers' deposits and dis-intermediation steadily eroded the intrinsic advantages of holding a commercial banking license (IMF 1993: 16-21). Some of these factors are currently at work in the newly created single European financial area and may well have similar outcomes. The growing trend to dis-intermediation, in which the development of the commercial paper market has played a significant part, is an example.

At the beginning of the 1980s, commercial paper markets existed only in Australia, Canada and the United States. Since then many new national markets and a Euro-market have developed. Commercial paper markets have been operating in the United States for many years but the market grew rapidly during the 1980s. By the end of the decade the amount of non-financial commercial paper outstanding represented 21% of commercial and industrial loans at banks compared with approximately 11 per cent in 1980 (IMF 1993:17). The development of commercial paper markets posed a dual threat to United States commercial banks during the 1980s. Firstly, it meant that many of their prime corporate borrowers ceased to be customers as they found they could raise short term funds more cheaply on the commercial paper market. Secondly, this contributed to a significantly changed pattern of bank lending with banks increasingly lending to finance real estate transactions and leveraged buy outs. It is only since the mid 1980s that commercial paper markets have developed in Europe (see table 2). This phenomenon still has a long way to go. As commercial paper markets mature in the 1990s European banks will face tighter margins and more difficult competitive conditions.

Other competitive pressures on banks in the United States which may pre-figure European developments included the development of the so-called 'junk' bond market for non-investment grade companies who would, previously, have borrowed money from banks. The development of the securitization of traditional bank assets such as mortgages, car loans, credit card loans and leases means that competitors could increasingly serve these markets without using the banking system. This is forcing a reassessment of the fundamental role of banks in a modern market economy (Fabozzi and Modigliani 1992: 319-21). Competition for deposits from money market mutual funds raised the costs of banks whilst changes in state and federal laws facilitated competition amongst banks. Non-bank banks were established by over 100 major companies and a number, including General Motors and Sears, chose to issue credit cards providing extremely effective competition (Smith 1993: 293; White 1992). In these circumstances some banks chose to tackle their problems by trying to grow out of trouble, expanding their nominal assets by taking on ever more marginal credits, particularly in the real estate sector which by 1991 accounted for 42% of total bank loans outstanding in the United States compared to 28% in 1980 (BIS 1992: 201). All too often, this proved a disastrous strategy (BIS 1993: 168-81; White 1992). Similar problems have already occurred in Europe. A notable recent example has been provided by the travails of Credit Lyonnais in France (The Banker 1994).

It should be noted that, serious though the upsurge in commercial bank failures was in the United States, the most expensive, intractable problem was resolving the savings and loans crisis. This cost the United States government an average US \$68 billion per year between 1988 and 1991 (BIS 1993: 171). There are many thousands of co-operative and savings banks in the European Union which account for a significant fraction of banking assets (EC 1993). It may be prudent to pay close attention to their regulation and inevitable future restructuring so that Smith's comments (1993: 41) on the United States savings and loan debacle do not apply to Europe in future:

'The S&L industry never bothered anybody before the early 1980s. It was fairly inconspicuous, as financial industries go, but it nonetheless accounted for about 30% of all insured banking assets in the United States. Subject to severe restrictions on its activities by regulation, the industry resembled a public utility - highly specialized, local, slow, and unsophisticated outside of its own field. Such industries are poorly equipped to deal with the ravages of rare sudden change in market economics.'

One unambiguous, easy to state, hard to practice, lesson from United States experience is that regulators need to look ahead. It may be true that regulators inevitably trail market developments in terms of new financial instruments as such instruments are often devised precisely to avoid existing regulations or to take advantage of differences in regulatory or tax regimes operating in different

jurisdictions. But it need not be true that bank supervisors must always trail behind structural developments in financial markets. The rapid structural changes being ushered in by the creation of the European financial area will have many of the same ingredients as those which affected the United States in the 1980s. There are many commercial, savings and co-operative banks, dis-intermediation and competition are on the increase, in some countries banks have enjoyed a long period of stability and are simply unused to competition and rapid change. European regulatory institutions are not automatically destined to follow the path trodden by the United States of which White (1992:10) observed:

'...from the 1930s onward, the bank regulatory agencies had relied on a stable economic environment, the protected positions of banks and the concomitant levels of implicit capital to help alleviate the burden of the safety and soundness of so many banks. When this combination of circumstances gradually dissolved, it was almost inevitable that the bank regulatory system would be overwhelmed.'

Another lesson is that it pays to have a fairly straightforward institutional structure for regulation. For example, one of the problems experienced in the United States was that some failed savings and loan banks and credit unions in Ohio, Maryland and Rhode Island were not covered by Federal Deposit Insurance. However, political pressure was such that de facto the depositors received their money (White: 19-20). The cost of thrift and commercial bank rescues combined with such experiences in the United States have prompted a substantial literature pointing to the danger that regulators may serve their own rather than social interests. It has even been argued that this disjuncture between the principals (taxpayers) and their agents (regulators) is the key to understanding the regulatory mess of the 1980s (Kane 1990). Competing regulators have an incentive to pursue policies which ensure that it is their agency which survives and gains power and influence. Concerns generated by regulatory capture and the pursuit of regulatory self interest are less widely expressed in Europe. However, the European Union will do well to avoid regulatory competition if its main outcome is to be to spawn significant principal-agent problems. In this connection, it is noteworthy that the Federal Reserve proposed in 1994 that the four agencies responsible for supervising banks in the United States be streamlined into one (IMF 1994: 13-4). United States experience in supervision underlines the importance of consolidated supervision and provides supporting arguments for the creation of a single European wide supervisory authority.

3.2.2 EU and Scandinavia

The experience of the three prosperous Scandinavian economies outside the European Community in the 1980s suggests that a combination of financial de-regulation, structural change and economic integration can lead to systemic financial crises (IMF 1993: 2-10). For example, Norway had a highly regulated economy which then was rapidly liberalized in the 1980s. The results were a disastrous credit bubble followed by a systemic crash during which the Norwegian banking system was effectively nationalized and loan losses were estimated to equal 4.2% of GDP, whilst government support for the banking system cost 2.8% of GDP (IMF 1994: 2-10). Reflecting on the experiences of the 1980s Norges Bank, the Norwegian central bank, supported the merger of the Norwegian Banking, Insurance and Securities Commission with itself. Its executive board outlined the arguments (Norges Bank 1992: 144) which included the following:

- The earnings and financial strength of financial institutions are strongly influenced by general economic conditions including housing and property.
- Financial instruments are becoming increasingly complex and thus tightening the interconnections between various markets.
- The transition to a market oriented regime necessitates more active risk management
- The increase in financial transactions means that financial institutions continually hold large open positions with each other. The central bank plays a key role in limiting the risk attached to settlements in the payments transmission system

- The Norwegian economy is becoming increasingly internationalized and integrated whilst sectoral dividing lines have been blurred.

3.2.3 BCCI - is it really relevant?

The main area of banking supervision in which there has been truly significant international agreement has been on the international convergence of capital measurement and capital standards. The 'Basle agreement' (BIS 1988) on bank capital adequacy has been translated into banking practice in all internationally significant jurisdictions. A second area to receive detailed, effective attention has been that of regulatory gaps generated by the internationalization of financial markets. The existence of such gaps and the need to create transparent corporate structures were highlighted by the closure of BCCI in July 1991. The story of BCCI is well known and has been discussed at length elsewhere (Bingham 1992; Henderson: 150-61; Norton: 81-4). From a supervisory perspective, the most important feature of the BCCI episode was that it showed that there were serious gaps in the regulation of cross-border banking establishments. In particular, it was clear that BCCI was not subject to consolidated, home country supervision as under Luxembourg law holding companies were not subject to supervision. The deliberately complex, opaque corporate structure created by the BCCI management enabled it to avoid supervision by a single authority (IMF 1992: 16-7). The response to the BCCI debacle has been that the Committee on Banking Regulations and Supervisory Practices, which meets under the auspices of the Bank for International Settlements in Basle, reformulated the 1975 Basle Concordat. The re-formulated principles which are now being applied provide, first and foremost, for the supervision of international banking groups and banks by a home-country authority that can capably perform consolidated supervision (IMF 1993:37). Other lessons learned from the BCCI episode are the need to promote greater corporate transparency and information disclosure to supervisors, that auditors should play a more pro-active role, that convergence in accounting standards is desirable and that the development of international insolvency laws and greater legalism generally are probably inevitable (Norton 1993). Kinsella (1995: 97) has recently argued that 'Even with agreed minimum prudential standards the EU will be left with a patchwork of different national capabilities. The BCCI debacle demonstrated the inherent weakness of such a system.' It is true that a single European authority would not have been prey to the regulatory gaps identified in the BCCI case. However, it is far from certain that the BCCI experience adds much weight to the case for a European supervisory agency as opposed to consolidated host country supervision. The international supervisory response has created a more robust system on a global as opposed to merely European scale. Furthermore, the main argument underpinning the case for a single European supervisory agency is the need to avoid systemic crises. The closure of BCCI, which operated in 70 countries, imposed losses and business disruption on depositors and customers. It did not cause systemic disruption within the international banking industry generally or within any individual national banking system. The general lessons to be learned from this episode seem to be the need to apply the minimum agreed standards of the re-formulated Basle Concordat which provide for the operation of effective, consolidated, home country supervision whilst providing host and home country authorities with powerful sanctions to ensure that corporate structures are transparent.

3.3 New problems for prudential supervisors

3.3.1 From the advent of the ECB

The creation of a unified monetary system requires the operation of a stable system through which monetary policy can be transmitted. Amongst the original tasks foreseen for the future European Central Bank was participation 'as necessary in the formulation, co-ordination and execution of policies relating to prudential supervision and the stability of the financial system'. (Goodhart 1992: 16).

The possibility exists that national regulators will try to pursue their own rather than social goals. National authorities will surely feel a responsibility to national polities. Furthermore they may try to shift both the political fall out from unpopular decisions and paying for problems to other European

taxpayers. Within the substantial United States literature these possibilities have been widely discussed. Boot and Thakor (1993) show that 'even a small degree of uncertainty about the quality of the regulator can create significant departures from social optima.' Competing regulators can have an incentive to delay the closure of a bank and inflate the liability of the deposit-insurance fund. If national regulators within the European Union begin to compete this may create problems. Secondly, the exercise of lender of last resort facilities is, by its very nature, a major intervention in competitive conditions. Such decisions are bound to be highly contentious. Amongst the contentious questions to be tackled will be who should take the decisions to intervene? Who should pick up the bill for intervention? What macro-economic policies should be followed after intervention? Will the outcome unfairly advantage a particular bank or group of banks - particularly any which are playing the role of 'national champion'.

In this light, consider the events surrounding the 1994 winding up of the leading Spanish bank Banesto (Banco Espanol de Credito). In brief, Banesto expanded very rapidly but injudiciously in the early 1990s. By the end of 1993 approximately 20 per cent of the banks loans were non-performing. In December 1993 the crisis came to a head and interim management was installed by the Bank of Spain. Over the next few months, the Bank of Spain and major commercial banks shared in absorbing 285 billion pesetas in losses. In addition 600 billion pesetas worth of problem loans were transferred to the Deposit Guarantee Fund. After this, in April 1994, the remnants of Banesto were sold at auction to Banco Santander. The result was the creation of Spain's biggest bank with a capitalization of 17.1 trillion pesetas (IMF 1994: 74). Had this operation been carried out after the creation of a single European currency and monetary policy it would have generated significant additional concerns. In particular, competitors would have been concerned that the creation of a large, new European bank in such a way would have created an unfair competitive advantage by means of a generous taxpayer subsidy. Who is responsible for devising and implementing liquidity pooling and loss sharing mechanisms.

4 The way forward

The various changes in the European financial system point to a number of challenges that bank supervisors will have to confront. These will require development of the institutional framework for supervisory and pose the question of how extensive an involvement the EU tier of governance should have in this area.

4.1 3 c's and their advantages/drawbacks

As noted above, cross-border arrangements of various strength can be envisaged. US experience suggests that co-operation is not enough and that co-ordination poses problems where supervisors have differing goals and incentives. It is also instructive that in the development of the US system, it was felt necessary to confer some responsibilities on the federal tier of government. Given the way the European financial area is developing, the present co-operative arrangement will probably have to give way to a more formal setup. There are two broad reasons for this:

- First, as banks take on a growing proportion of business from other Member States, the incidence of potential 'externalities' in jurisdictions outside that of the supervisor will increase¹.
- Second, the context of systemic risk will become the whole of the European financial system rather than the individual Member State.

Formal co-ordination of supervision, whether under the auspices of the EMI or the Bank of International Settlements may be a sufficient answer, especially in the light of the general preference articulated in the Treaty for adhering to the principle of subsidiarity. However, there is some danger that a system in which Member States are free to set their own standards will encourage an excessive watering down of prudential controls in order to secure competitive advantage. Such 'supervisor shopping' or, to adapt a well-used phrase, 'prudential dumping' could increase the prospects of financial instability (Norton, 1994)

Some centralisation of supervisory functions therefore seems warranted. In this regard, it is worth distinguishing between different classes of banks. For small bank either operating in a specialist 'product' or regional market segment, the cross-border implications of their activities will be minimal, and their organisation and structure will be specific to that market segment, so that a national supervisor will probably be best placed to deal with such a bank. At the other extreme, there is a persuasive case for going beyond home country control to make banks which are pan-European in scope subject to an EU tier supervisor. This would inevitably raise questions about the nature of the supervision and could create problems if banks which compete directly in some market segments were subject to different supervisory régimes.

4.2 Institutional and political constraints

Assessment of the case for involving the supranational tier in prudential supervision cannot rely solely on conceptual arguments, because there are political, legal and institutional grounds for caution. The political objections are both the most straightforward and the most intractable. Respect for the principle of subsidiarity implies that there have to be manifest advantages to justify bringing in the higher tier, and it is inevitable that Member States will play down any such suggestion. In these circumstances, and particularly in the current political climate in Europe, proposals for change will not be well received.

Legal and institutional constraints start from the fact that the Treaty confines itself to establishing the ECB and the ESCB. Thus, there is no provision for a stand-alone supervisor similar to the banking commissions that operate in some Member States, nor is there any suggestion that bodies other than central banks should be part of the ESCB. Yet the open-ended clauses concerning prudential supervision are framed only with reference to the ECB and the ESCB. A related point is that competition considerations have led to the adoption in the EU of the Second Banking Directive, enshrining home country control. Baltensperger and Dermine (1993) argue that although this is sound from the perspective of consumers, in that it enhances choice and reduces redundant supervision, it increases systemic risk. The problem is that to reverse the thrust of the single market would run counter to recent institutional trends. A possible solution is to confer greater powers on the supranational tier.

5 Proposals and conclusions

Although it would, no doubt, be possible for the EU to persevere with the current arrangements for prudential supervision, consolidation of the European financial area is likely to make this increasingly unsatisfactory. This leads to the conclusion that at least some supervisory tasks should be shifted 'upwards' to the European tier.

5.1 Case for some EU tier competence

A number of arguments support the case for assigning responsibility for prudential supervision to the EU tier. A first is that it would make it easier to assure the stability of the financial system in a period of turbulent change. The significance of prudential safeguards in a period of financial liberalisation have been underlined recently by Borio and Filosa (1994: 38) '...the serious difficulties encountered by some Nordic banking systems have in part reflected the failure to strengthen prudential safeguards sufficiently in a liberalised, more competitive financial environment'.

A second major theme is that a major part of the single market programme is to foster the emergence of a single European banking and financial area. By its very nature this project will involve major structural change. Amongst these changes may well be the creation of pan-European banks. If and when such institutions develop it is logical that a European Union wide authority should bear the burden of lender of last resort intervention. This gives rise to the most straightforward argument for assigning supervisory responsibilities to a European Union wide body. This has recently been expressed by Kinsella (1995: 97) as follows: '...there is a need for an EU-wide regulatory authority as a natural counterpoint to the single market in financial services'.

The basic rationale for creating a single market in financial services is to promote competition and gain the benefits which will arise from overcoming existing segmentation. Key and Scott (1991) stress that the 'choice of a rule depends on the interaction between two factors: the manner in which the service is provided and the public policy goals underlying the regulation of banking services'. Proponents of the two arguments give different weights to the public policy goals of stability and efficiency. Steinherr (1992: 3) points out that regulations were largely established to deal with the needs of the past. Here we are trying to design regulations for the future. The main brake on the liberalization process has been prudential concerns, although these have also been a pretext for residual protection of indigenous operators. The issue is to what extent should issues of stability be prioritised over allocative efficiency. After all, the fundamental case for de-regulation is that it enables firms to decide on the product mix that they think they are best suited to provide and to test the market accordingly. What rules can be derived from Borio and Filosa's observation that '...experience indicates that securing the benefits of deregulation in terms of greater economic efficiency calls for a strengthening of prudential safeguards with a view to limiting the risk of financial instability' (Borio and Filosa: 42).

A third major theme is that economic integration requires the development of a single European clearance and settlements system. Such a system will be overseen by the ECB, and will have to establish appropriate liquidity-pooling and loss sharing mechanisms to ensure settlement in specific systems in the event of a failure to settle on the part of individual participants. As Borio and Van den Bergh (1993: 64) argue: '...the most important challenge is introducing appropriate liquidity-pooling and loss sharing mechanisms to ensure settlement in specific systems in the event of a failure to settle on the part of individual participants .. the resolution of a settlement failure relies excessively on the central bank to provide emergency liquidity assistance, to the detriment of transparency and incentives for prudent behaviour.' A corollary will be supranational policing of the financial intermediaries involved.

A fourth consideration is that the advent of a single European currency and a European Central Bank will mean that prudential supervision will be much more remote than at present from monetary policy. In this regard, an argument for retaining home country control is that it is better to separate monetary policy from supervisory policy in case monetary policy is compromised. Gerry Corrigan (1993: 12), former President of the Federal Reserve Bank of New York has robustly argued against this 'I will concede that in the short run, the potential for such conflicts exist. But in my experience I have never encountered a situation in which that potential became a reality to the detriment of monetary policy. Moreover at the end of the day, that potential conflict disappears because price stability and financial stability become opposite sides of the same coin. That is why the central bank, in my judgment, has an inherent and ongoing interest in supervisory policy and practice.' This argument, which stresses the synergies between monetary policy and supervisory practice provides a further rationale for creating a European Union level supervisory authority which would then form part of the operation of the future European Central Bank. After a decade of dealing with difficult supervisory problems, the US Federal Reserve has argued that the central bank responsible for monetary policy should be the lead supervisor for banks (IMF 1994:14). Amongst the reasons put forward for this position are that:

- The central bank's role in resolving financial crises makes it imperative for it to have a close and continuous knowledge of the position and workings of banks - knowledge that can only be gained from hands on supervision².
- When the central bank has close proximity to markets and to banks there are important synergies for the formulation of monetary policy because the central bank will be more sensitive to key financial sector developments. For example, the Federal Reserve argues that its supervisory role helped it to be more sensitive to the credit crunch in 1991-2.
- The central bank's supervisory role makes it easier for the central bank to get information useful for monetary policy from banks.

Finally, it may be argued that divided regulatory responsibilities will cause confusion and problems of regulators pursuing their own rather than broader social goals. It is important to establish explicit responsibility for managing crises before they happen. Not only must it be clear who is responsible but also who pays. Institutional arrangements such as whether supervision should be a task of the ECB or whether there should be a separate commission will matter, but are probably of secondary importance.

The duty of prudential supervision invests the responsible authority with considerable power of intervention. It is best to recognise at the outset that this will inevitably lead to controversy. In the establishment of the European Central Bank close attention must be paid to the parameters within which the Bank will be able to exercise its discretionary powers. Initially, the Bank will operate on the basis of the guidelines and accords already agreed under the auspices of the Bank for International Settlements. However, these rules do not provide a deterministic framework within which decisions on lender of last resort intervention are always clear. Recently, the contrast in the response of the Bank of England and the Bank of France to the travails of Barings and Credit Lyonnais respectively have shown how wide the power of discretion is in practice (The Banker 1995).

It is likely that the anticipated pace of change in the European banking and financial industry will generate some specifically regional/national problems which will become of European wide significance because of their potential cost and wider economic impact. During the 1980s in Texas, for example, extensive, costly assistance was provided by the Federal authorities to institutions which failed in specific states due to a combination of local economic circumstances, mismanagement and inappropriate regulation. Within the European Union such extensive intervention would be much more problematic because the Union lacks the cohesion and legitimacy conferred by nation- statehood. In these circumstances, the rules within which the ECB is to operate assume greater significance as discretionary decisions are more likely to be challenged on potentially highly divisive, national grounds. One response to this is to design the ECB with an explicitly Federal structure which provides for European wide supervision of a limited number of institutions which pass certain tests connected with size and operational scope within the EU. An agreed framework of rules from the outset within which discretionary intervention might take place would confer legitimacy on the operations of the Bank or other supra-national agency responsible for prudential supervision. A further way of enhancing the Bank's legitimacy would be to design the ECB as a Federal institution which would operate in such a way that supervisors based in institutions within the individual EU states would retain the first responsibility for supervision and intervention for the great majority of institutions. A corollary of this is that the ECB will be accountable both to a European wide institution (Council of Ministers or European Parliament for example) and have a duty to, at least, report to national parliaments. One difficulty, however, is that only the ECB and the ESCB are given legal standing in the Treaty. If there is to be supranational supervision within the existing institutional structure it would probably have to take this route. This implies some problems in integrating the separate supervisory authorities into the ESCB in those member states where the Central Bank does not formally supervise financial intermediaries.

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Table 1 Supervision of credit institutions in EU Member States

Member State	³ Agency responsible for ³ prudential supervision	³ Remarks
Austria	³ Ministry of Finance	³ Banks are required to report to Central Bank
Belgium	³ Banking Commission	³ One of six Commissioners is from the Central Bank
Denmark	³ Supervisory Authority	³ Accountable to Ministry of Industry
France	³ Banking Commission	³ Chaired by Central Bank Governor
Germany	³ Supervisory Office	³ Advisory and consultative role for Central Bank
Ireland	³ Central Bank	³ Central Bank also supervises other intermediaries
Italy	³ Central Bank	³ Central Bank has other supervisory tasks
Luxembourg	³ Monetary Institute	³ In process of becoming a fully-fledged Central Bank
Netherlands	³ Central Bank	³ Central Bank also regulates banking sector
Portugal	³ Central Bank	³ Central Bank also supervises money markets

paper

Japan	1987-	104.8	98.1	
United States	pre-1960	326.1	521.9	544.9

Source: (Alworth and Borio 1993:12)